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0. Statement of Qualifications

My name is William H. Lehr. My business address is 94 Hubbard Street, Concord, MA 01742.

I am an associate research professor of finance and economics at the Graduate School of Business of Columbia University. Prior to joining the Columbia faculty in 1991, I received my Ph.D. in economics from Stanford University. My M.B.A. (Wharton), M.S.E. (chemical engineering), B.S. (chemical engineering, *cum laude*), and B.A. (European history, *magna cum laude*) degrees are from the University of Pennsylvania. I have significant professional experience in the telecommunications industry both as a consultant and, previously, as an employee of MCI.

My research focuses on issues in telecommunications economics and policy. I have authored a number of professional articles on standard setting, telecommunications policy and network economics. My *curriculum vitae* is attached as Exhibit 1.

I. Introduction

With the signing of the World Trade Organization's basic telecommunications agreement on February 15, 1997 (WTO agreement), and the publication of proposed rules by the Federal Communications Commission (FCC) to reform settlements (the FCC's settlements NPRM)[1] and foreign entry requirements (the FCC's foreign entry NPRM)[2], US policy-makers moved aggressively to promote increased competition in international telecommunications markets.

Increased competition and openness in foreign markets will benefit US (and foreign) consumers by lowering international telephone rates and by strengthening the competitiveness of US firms by eliminating the unfair advantage accruing to foreign firms because of their market power abroad and because of excessive international settlement rates. International settlement rates which exceed economic costs continue to provide a multibillion dollar subsidy to foreign telecommunications carriers.[3] These subsidies cause US outbound international toll

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[1] *Notice of Proposed Rulemaking in the Matter of International Settlement Rates*, Federal Communications Commission, IB Docket No. 96-261, adopted December 19, 1996.

[2] *Order and Notice of Proposed Rulemaking in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market*, Federal Communications Commission, IB Docket No. 97-142, adopted June 4, 1997.

[3] According to the recent FCC NPRM, "The United States paid roughly $5 billion in settlements to the rest of the world in 1995, up from $2.8 billion in 1990.... Based on our estimate of the costs of international termination services, we estimate that at least three-quarters of the $5 billion in out payments is such a subsidy from U.S. consumers, carriers and their

prices to be higher than is necessary and provide a large pool of excess profits that may be used to fund anticompetitive activities both in the US and abroad. The profits from high settlements reduce incentives to open foreign markets to increased competition and encourage wasteful investments in regulatory rent-seeking.

In recognition of this danger, the FCC is recommending that foreign carriers adopt settlement rates which fall within a benchmark range.[4] While any reduction in settlement rates is to be applauded, it is important to note that the upper bound of the benchmark ranges are significantly above economic costs. Therefore, rates which are below the upper bound do not eliminate the threat of anticompetitive activity. The FCC's recent recommendation to liberalize foreign entry requirements[5] increases the need to move settlement rates toward economic costs more quickly, lest foreign entrants take advantage of high settlement rates to harm the competitive process in the US.

In this affidavit, I explain why the FCC ought to require foreign carriers to adopt cost-based settlement rates *before* allowing the US-subsidiary of a foreign carrier to offer international services between the US and its home country. These

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shareholders to foreign carriers." (see *Notice of Proposed Rulemaking in the Matter of International Settlement Rates*, note 1, *supra*, paragraph 8.

[4] See *Notice of Proposed Rulemaking in the Matter of International Settlement Rates*, note 1, *supra*.

rates should coincide with the lower bound of the benchmark range proposed in the FCC's settlements NRPM unless the carrier is able to provide appropriate data demonstrating that foreign termination costs exceed this lower benchmark bound. Furthermore, these rates should apply regardless of whether the foreign-owned subsidiary seeks to offer services as a facilities-based carrier or as a reseller.

Section II discusses the current state of competition in US domestic local and long distance markets and how this relates to efforts to promote increased international competition. Section III demonstrates how above-cost settlement rates can harm US competition and consumers. Section IV discusses why the FCC's proposed remedies do not go far enough and explains why it is advisable to require cost-based settlement rates as a prerequisite. Section V offers summary conclusions.

II. Telecommunications Competition and Regulatory Reform

Competition benefits consumers by encouraging lower prices, improved quality, and expanded customer choice. Protecting and promoting competition provides the surest way for policy-makers to benefit consumers. Today, we have effective competition in US long distance markets; however, both the

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[5] See *Order and Notice of Proposed Rulemaking in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market*, note 2, *supra*.

markets for local and international services are not adequately competitive.

Domestic local service markets are dominated by monopolist providers, collectively referred to as incumbent local exchange carriers (ILECs). In contrast, domestic long distance markets are characterized by robust competition. Effective long distance competition emerged in the years following the divestiture of the Bell System in 1984. In domestic long distance markets, customers can choose among hundreds of national and regional, facilities-based and non-facilities-based interexchange carriers (IXCs). However, most customers have only a single choice for their local service provider. The history of significant entry and exit, declining price and market share trends, aggressive marketing behavior, and the actions of consumers as they move in large numbers from one IXC to another all provide ample evidence of the vigor of long distance competition. When applied to local services, however, similar measures indicate the complete absence of effective competition.[6]

The Telecommunications Act of 1996[7] (the Act) seeks to promote increased competition in local services by requiring the ILECs to unbundle their networks and interconnect with competitive local exchange carriers (CLECs) at cost-based, non-

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[6] For further discussion of the state of long distance competition, see B. Douglas Bernheim and Robert D. Willig, *The Scope of Competition in Telecommunications*, AEI Studies in Telecommunications Regulation, Washington DC: American Enterprise Institute, 1997, forthcoming.

[7] *Telecommunications Act of 1996*, Pub. L. No. 104-104, 110 Stat. 56.

discriminatory rates.[8] These policies are necessary to facilitate the emergence of effective local competition because large scale entry is not economically feasible without affordable access to the incumbent's network.

The competitive situation in international services is more complex. On the US outbound-side, international services are as competitive as domestic long distance services; however, the foreign markets on the other end are typically much less competitive. In many cases, the foreign markets are dominated by an integrated monopolist. Even in cases where foreign long distance services are open to competition, local services are dominated by a single monopoly provider which is also integrated into long distance services.[9]

As is the case with monopolists everywhere, these foreign carriers are jealous of their market power and relinquish it only reluctantly. Foreign consumers bear the cost of this in the form of higher prices because of cost inefficiencies and because of the desire of the incumbent carriers to extract and protect monopoly profits. This asymmetric market power and these higher costs are reflected in international accounting agreements. These agreements specify the settlement rate which is used to assess the cost of terminating international traffic

[8] See *Telecommunications Act of 1996*, note 7, *supra*, sections 251 and 252.

[9] This is the case in such markets as the UK, Chile, and New Zealand, which have introduced significant amounts of long distance competition. Several of these markets have also taken important steps towards introducing local competition.

abroad. These settlement rates dramatically exceed the actual costs incurred by foreign carriers. These settlement rates provide a large, multibillion dollar subsidy from US carriers, their investors, and their customers to these foreign carriers. According to the FCC's settlements NPRM, "It is not unusual for settlement rates to be between five and ten times a reasonable estimate of the underlying cost of terminating an international call."[10] These excessive settlement rates are reflected in international toll rates which are much higher than necessary, directly harming US (and foreign) consumers.

The desire to protect this lucrative stream of excess profits induces these carriers to resist efforts to open foreign markets to increased competition and to move settlement rates closer to costs. The settlements subsidy provides a ready source of funds with which to fund these anticompetitive efforts.

Furthermore, efforts to avoid high settlement rates can distort investment and network operating decisions, inducing carriers to configure their networks to avoid settlement charges rather than to minimize costs and improve service quality. These negative impacts extend to US domestic markets because US carriers are required to pay these charges in order to terminate international traffic. The FCC's recent settlement and foreign entry NPRMs identify a number of anticompetitive strategies which

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[10] See *Notice of Proposed Rulemaking in the Matter of International Settlement Rates*, note 1, *supra*, paragraph 7.

might be employed by a foreign carrier with market power in its home market or to exploit excessive settlement rates.[11]

In the past, US markets were partially protected by regulatory policies which sought to enforce reciprocal competitive treatment as a pre-condition for allowing foreign participation in US markets. Foreign carriers were required to pass an effective competitive opportunities (ECO) test. The lure of participating in US markets offered a powerful inducement to open foreign markets to increased competition and helped deter anticompetitive activities. Now, in its foreign entry NPRM, the FCC is proposing to unilaterally relax entry restrictions and dispense with the ECO test requirement for foreign affiliates in WTO signatory countries. This is unfortunate because it removes a powerful inducement for foreign carriers to cooperate with the successful implementation of the WTO's agreement.

If foreign markets were competitive, there would not be a problem because prices would approximate economic costs -- that is, the lower bound of the benchmark range specified in the FCC's settlements NPRM. Unfortunately, this is not the case and according to the FCC's data, the average settlement rate paid by US carriers is $0.36 per minute compared to an estimated economic cost for terminating costs of $0.06-$0.09 per minute,

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[11] See *Notice of Proposed Rulemaking in the Matter of International Settlement Rates*, note 1, *supra*, paragraphs 11-13, or *Order and Notice of Proposed Rulemaking in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market*, note 2, *supra*, paragraph 90.

representing an over four- to six-fold mark-up over true costs.[12] Now, the FCC is proposing to condition facilities-based foreign entry into US outbound international services on the foreign carrier agreeing to a settlement rate within the benchmark range specified for traffic between the US and the affiliated foreign market.[13] The upper bounds for the benchmark rates range from $0.154 per minute for the most developed countries to $0.234 for the least developed countries. While the promise of rates within the upper bound offer an important improvement over current conditions, these rates still reflect a two- to four-fold markup over economic costs. Furthermore, the FCC does not apply this requirement to resellers, even though resale entry may prove the most effective means for employing an anticompetitive "price squeeze" strategy of the type discussed in Section III.

Because these markups represent an important source of excess profits to foreign carriers, there is little incentive for carriers to do more than adopt the upper bound of the range.[14] Also, foreign carriers who enter as resellers -- not as facilities-based providers -- are not even subject to this

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[12] See *Notice of Proposed Rulemaking in the Matter of International Settlement Rates*, note 1, *supra*, paragraph 34.

[13] See *Notice of Proposed Rulemaking in the Matter of International Settlement Rates*, note 1, *supra*, paragraph 76, or *Order and Notice of Proposed Rulemaking in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market*, note 2, *supra*, paragraph 119.

[14] Competition among competing providers of network termination facilities in the foreign home market offers another mechanism for driving settlements towards costs. However, such competition does not currently exist and foreign incumbents have a powerful incentive to use whatever means available to resist

relatively weak restraint on their anticompetitive behavior. If the FCC is committed to liberalizing foreign entry requirements by dispensing with the ECO test, then the FCC ought to adopt a tougher requirement for international settlement rates. Foreign carriers whose US-based subsidiaries wish to offer international service to their affiliated country should be required to adopt cost-based settlement rates as a pre-condition for offering such service. These cost-based rates should coincide with the lower bound of the benchmark range[15] and should apply regardless of the method by which the foreign-owned subsidiary seeks to provide service.

In the absence of such a rule, there is a significant danger of anticompetitive behavior by the foreign-owned subsidiary. In addition to using the excess settlement profits to fund the sorts of anticompetitive behavior noted in the FCC's NPRM,[16] there is the danger that the foreign subsidiary will engage in a "price squeeze" in order to stimulate additional settlements subsidies and to facilitate unfair competition

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the emergence of such competition -- including seeking to raise the costs of potential rivals such as US-based IXCs.

[15] If the carrier can provide appropriate cost data indicating that economic costs exceed the lower benchmark range estimated by the FCC, then this "better" estimate of economic costs ought to be used to establish the cost-based settlement price. It should be noted, however, that the appropriate standard is the forward-looking, long-run incremental cost that would be incurred by an efficient carrier. This is unlikely to match the current or embedded costs of a monopoly carrier that is unlikely to be efficient.

[16] See note 11, *supra*.

against US-based IXCs. The next section explains how such a price squeeze could result.

III. Settlement Rates and the Effect on Competition

Settlement rates which exceed economic costs can facilitate a price squeeze that would harm both consumers in the US and abroad, and would harm the competitiveness of US telecommunications markets. One mechanism for doing this would be for a foreign carrier to acquire a US subsidiary with an eye towards stimulating increased settlement subsidies. The foreign-owned subsidiary could achieve this, for example, by initiating a price war in order to lower long distance prices in the US. Nominally, such competition may *appear* beneficial because it results in lower prices for consumers in the short-run. Furthermore, the observation of suddenly lower prices in the short-run would lend credence to arguments that long distance markets in the US are not presently competitive. If this counterfactual state were the case, then increased competition -- either from foreign entrants, or more likely from Bell Operating Companies that are presently restricted by the Act -- would be expected to lead to lower prices. On the other hand, if long distance markets are already effectively competitive as noted earlier, then additional entry from any source is unlikely to significantly affect the extent of competition or long-run prices.

In a competitive market, the only way to lower prices is to lower costs. Any form of below-cost pricing is anticompetitive, and by threatening the competitive process, is harmful to consumers. Even though a foreign entrant to the US would be unlikely to have a significant cost advantage, the subsidies inherent in above-cost settlement rates or due to the foreign carrier's market power in its home or other markets could be used to subsidize such a price reduction. The foreign carrier may be motivated by a desire to subsidize entry into US markets[17], to raise rivals costs[18], or to generate additional settlement subsidies. The lure of earning settlement profits could induce a foreign carrier to be willing to sustain losses for its subsidiary in order to capture additional settlement subsidies.

A simple example can illustrate how this could occur (see Exhibit 2). Consider the case of traffic between the US and the hypothetical foreign country ARGMEX. Let us assume that the symmetric total service long run incremental cost (TSLRIC) of originating or terminating a minute of traffic in the US or

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[17] For this to be rationale, it is not necessary to assume the foreign carrier is pursuing a traditional predation strategy (i.e., pricing below cost to drive competitors from the market and thereby establish market power which would enable prices to be set higher in the future). The foreign carrier may seek to establish a position in long distance as a Trojan Horse to lever its market power into other, less-competitive sectors.

[18] Sometimes the best defense is a strong offense. Any action which weakens US IXCs will reduce the threat that they will participate in increasing competition in the foreign carrier's home market.

ARGMEX is $0.10 per minute[19], that the retail-level costs are $0.05 per minute[20], and the current settlement rate is $0.25 per minute. With these assumptions, the total cost which must be recovered by a US carrier is $0.40 per minute. Let us further assume that the US market is effectively competitive so that prices approximate economic costs. Therefore, the average price for an outbound call to ARGMEX would be $0.40 per minute. With 1 million minutes of net outbound traffic between the US and ARGMEX, total US industry revenues (= costs, by assumption) are $400,000, of which $150,000 represents a settlement subsidy from US consumers to the ARGMEX carrier.

This subsidy of $0.15 per minute can be used by the ARGMEX carrier to pursue anticompetitive strategies in the US and abroad. The ARGMEX carrier can use it to protect its home market from competition or to subsidize its entry into US markets.

Consider what would happen if the ARGMEX carrier bought a US-carrier with a 10 percent market share. This carrier could reduce prices below cost by $0.10, which would stimulate additional outbound traffic. Assuming a demand elasticity of 0.7,

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[19] This cost is intended to include all of the capital and operating costs which would be incurred by an efficient IXC providing wholesale services. Therefore, this estimate includes a fair return on invested capital (what accountants refer to as "normal profits"). This estimate would not include true common costs (*i.e.*, costs which are not directly allocable), but for the purposes of this discussion I will assume these are negligible, or already included in the estimate of TSLRIC.

[20] This is the TSLRIC which would be incurred by an efficient reseller. Wholesale and retail costs are presented separately to demonstrate that the price squeeze strategy is not affected by how the foreign carrier chooses to entry.

this price reduction -- if followed by competitors -- would generate 175,000 additional minutes of traffic at the new outbound price of $0.30 per minute.[21] As can be seen in Exhibit 2, the effect of this price cut is to impose a loss of $117,500 on US-based carriers,[22] while increasing the settlements subsidy to the foreign carrier by $26,250.[23] Because the foreign subsidiary bears only 10% of the US carrier loss, or $11,750, the net effect on the foreign carrier from this strategy is a gain of $14,500!

While it is clear that US carriers are harmed by this form of subsidized competition, it appears that US consumers gain because the prices they are being asked to pay for international calls to ARGMEX have fallen by $0.10.[24] This gain is illusory, however, because at the new price, firms fail to recover their operating costs. Firms must be able to expect to recover their forward-looking costs, including a fair return on invested capital, in order to be willing to continue to invest in network

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[21] With an elasticity of 0.7, the hypothesized $0.10 per minute price cut represents a 25% reduction, which implies a 17.5% increase in minutes.

[22] The price cut imposes a loss of $0.10 per minute on US carriers because settlements and costs are unchanged. Total demand after the price cut is 1,175,000 minutes so the total loss is $117,500. Of this, 10% or $11,750 is borne by the foreign-owned subsidiary and the remaining $105,750 is borne by other US carriers.

[23] Each extra minute of outbound traffic earns a settlement subsidy of $0.15 (= $0.25 settlement rate - $0.10 TSLRIC termination costs). The price cut stimulates an additional 175,000 minutes, earning an additional $26,250 in settlement subsidies (= $0.15*175,000).

[24] In this example, the apparent static increase in consumer surplus is $108,750 (assuming linear demand). This gain is funded by transferring short-run surplus from US carriers to consumers. Because this surplus is needed to recover long-run operating costs, it is not sustainable.

infrastructure. In this example, the loss imposed on US carriers represents 33% of their revenues (costs) and is unlikely to be sustainable without severe harm to US industry and consumers.

Reducing settlements to costs (*i.e.,* from $0.25 to $0.10 per minute), however, would allow US carriers to reduce prices by an even larger amount from $.40 to $0.25 per minute. This would result in a real gain for consumers and would improve, rather than harm the competitive process in the US. Prices should reflect economic costs and settlement prices which exceed costs drive a wedge between the costs faced by a US carrier and true costs faced by a US-based foreign subsidiary.

The danger of such a price squeeze strategy does not depend on the mode of entry by the foreign carrier. Wholesale markets in the US for long distance are, if anything, even more competitive than retail markets. The existence of excess capacity and a fluid market of resellers significantly reduces the costs of long distance entry. Indeed, many of today's facilities-based providers entered initially as resellers. Because wholesale services are competitive, the wholesale price should reflect the economic costs of the wholesaler. Moreover, the reseller market is also competitive because entry costs are so low. Therefore, in a sustainable competitive equilibrium, the retail price should be equal to the wholesale price plus the incremental costs of retailing. In our example, this yields a wholesale price of $0.35 per minute.[25]

Exhibit 3 demonstrates that reseller entry has no effect on the net profits earned by the foreign carrier from pursuing this price squeeze strategy. The foreign-subsidiary's costs are the same. It merely pays in resale fees the network operating costs and settlement fees that it avoids by being a reseller.

While the mode of entry does not affect the attractiveness of executing the price squeeze strategy, resale entry has several important advantages. First, according to the FCC's proposed policy, entry via resale is not subject to the requirement that the settlement rate be within the benchmark range: the higher the settlement rate, the more attractive the strategy. Second, the FCC appears to regard resellers as less effective competitors, and hence, may be likely to monitor anticompetitive behavior by resellers less closely.[26] In any

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[25] The wholesaler's costs are $0.35 per minute, consisting of the TSLRIC network operating costs of $0.10 per minute and the settlement cost of $0.25 per minute. Only facilities-based carriers pay settlements. The cost borne by the facilities-based carriers is the same irrespective of whether the minute is a retail or wholesale minute. The retail-level incremental cost is assumed to be $0.05 per minute in this example.

[26] According to the FCC:

> "Our regulation of U.S. international services traditionally distinguishes between facilities-based service and resale for two reasons. First, facilities-based carriers have greater freedom than resellers to set prices because the authority they exercise over provisioning and configuration of facilities provides a high degree of control over costs not available to resellers. Second, facilities-based carriers' ability to configure facilities and route traffic according to their specific needs provides them with significantly greater ability than resellers to engage in anticompetitive conduct, especially where

case, monitoring of the foreign carrier's behavior is complicated by the fact that the essential bottleneck facilities are overseas. Third, entry by resale is much less expensive and less capital-intensive. Therefore, it is less risky and can occur more rapidly (*i.e.,* the sooner a foreign carrier can enter, the sooner it can start earning additional settlement subsidies for its parent).

The above example is quite general. Although the specific estimates of damages depend on the numbers provided, the overall conclusion remains: high settlement rates provide a powerful incentive for a consolidated foreign carrier to engage in a price squeeze strategy. The smaller the market share of the foreign subsidiary[27] and the more elastic is demand[28], the greater the foreign carrier's incentive to engage in this strategy.

Given the magnitude of the loss, it is worth considering whether competing US carriers could be expected to follow a price cut that does not allow them to recover their true

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> they control bottleneck facilities. As a result, we have historically scrutinized facilities-based carriers more closely than resellers in both the entry and post-entry contexts."

See paragraph 124, *Report and Order in the Matter of Market Entry and Regulation of Foreign-affiliated Entities*, Federal Communications Commission, IB Docket No. 95-22, adopted November 28, 1995.

[27] A smaller market share for the foreign subsidiary means that it incurs a smaller share of losses due to a price cut. The relevant market share is of the traffic between the US and the foreign market and needs to be large enough to credibly affect the pricing policies of US firms. How large a market share is necessary depends on the dynamics of competition in the market.

[28] More elastic demand means that a smaller price cut results in greater stimulation of outbound minutes, earning the foreign carrier settlements profits for each additional outbound minute.

long-run economic costs. The answer is yes! Most of the costs incurred by an IXC are fixed or sunk in the short-run. Typical estimates of short-run incremental capacity costs (excluding settlements) are on the order of a few cents. Failure to match a competitors price is likely to result in a loss of market share, which once sustained may be hard to reverse in the future. Furthermore, customers who leave to take advantage of cheaper calls to ARGMEX are likely to take all of their traffic to the new carrier (including domestic long distance and local service business). This will reduce the revenue available to recover IXC fixed and common costs.

The real case is further complicated by the fact that settlements are paid only for net outbound minutes (*i.e.,* total outbound minutes minus total inbound minutes). Because more minutes originate in the US than abroad, US carriers pay settlements to foreign carriers. One reason for this traffic imbalance is because of the lower prices which prevail in the US as a consequence of the more vigorous competition in long distance markets and the effectiveness of local service regulation. Therefore, the full effect on foreign carriers must also take account of the excess margins earned on return traffic which originates in the foreign markets.

In the US, the access charges paid to ILECs provide an additional subsidy that is similar in effect -- but smaller in magnitude -- to the subsidy embedded in excess settlement rates.

However, in the US, this subsidy is not captured by IXCs while the equivalent version of the access subsidy abroad is captured by the foreign carrier. Therefore, the foreign carrier may earn additional profits on return traffic to the US if additional return traffic is stimulated by the reduction in the US outbound price.[29] Foreign carriers may use private lines or other techniques (*e.g.*, call-back services) to bypass settlements on returning minutes. While the ECO-test sought to restrain such asymmetric strategies in the past, the FCC's current rules make this possible.

Finally, the example cited above presumes that the foreign carrier is a monopolist and therefore captures all of the incremental settlement subsidy generated. On the other hand, as noted earlier, the existence of effective competition in foreign markets should drive settlement prices towards economic costs and the problem would cease to exist. However, this is not the case. Even those countries which have introduced significant amounts of competition into long distance services have monopoly providers for local services. Furthermore, even if there were multiple providers abroad, excessive settlement rates provide a powerful incentive for them to collude in their efforts to manipulate international competition from the US.

[29] The benefits of this return traffic may be partially offset by a reduction in settlements revenue because of the reduction in net US outbound minutes when return traffic increases.

In summary, therefore, regardless of how US carriers respond to the price cut, it will have a negative effect on US competition. Its overall impact will be to stimulate additional settlements subsidies to the foreign carrier. The simplest way to remove this danger is to remove the incentive to capture excess settlement subsidies by moving settlement rates in line with economic costs. In the example above, the foreign firm ceases to be interested in manipulating international traffic if the settlement price is reduced to cost, or $0.10 per minute.

Finally, the failure to require cost-based settlement rates as a pre-condition to participation in the US market, reduces incentives for foreign carriers to reduce settlements voluntarily and to cooperate in efforts to open their markets to increased competition as required by the WTO agreement. At the same time, these subsidies provide a war chest with which to resist these pro-competitive changes.

IV. Effectiveness of Proposed FCC Remedies

I have explained already why settlement rates which exceed costs pose an anticompetitive threat that is not eliminated by rates that are within the benchmark bounds but still exceed the lower bound.

In its earlier foreign entry order, the FCC discounted the danger of a price squeeze, arguing (1) that foreign termination services may not be a bottleneck because there may exist alternative service providers[30]; (2) that, in any case, foreign carriers are not able to set the settlement rate "unilaterally"[31]; and, (3) that even if a price squeeze occurs, US carriers can reduce costs elsewhere to avoid competitive harm.[32]

The first two arguments are correct, but irrelevant: no one disputes that present settlement rates are significantly above economic costs. Moreover, while it is true that competition in the foreign market would move settlement prices towards economic costs -- thereby destroying the opportunity to behave anticompetitively -- such competition does not exist today.

The third argument is more puzzling. First, evidence that US long distance markets are already competitive suggests that there are no additional scale or scope economies or other cost savings which US carriers could avail themselves of to offset the losses imposed by a price squeeze. Second, even if additional cost savings were possible, the price squeeze would still be anticompetitive. At the very least it would harm resellers who are an integral part of the long distance competitive landscape. Third, any cost savings which could be

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[30] See *Report and Order in the Matter of Market Entry and Regulation of Foreign-affiliated Entities*, note 26, *supra*, paragraph 69, wherein the FCC notes that the existence of alternative suppliers for the bottleneck facility would destroy the foreign carriers ability to execute a price squeeze.

[31] See *Report and Order in the Matter of Market Entry and Regulation of Foreign-affiliated Entities*, note 26, *supra*, paragraph 69.

[32] See *Report and Order in the Matter of Market Entry and Regulation of Foreign-affiliated Entities*, note 26, *supra*, paragraph 70.

squeezed out of US industry ought to be captured by US consumers. These gains should not be transferred to the foreign carrier in the form of increased subsidies.

It appears that the motivation for the FCC's third argument against regarding a price squeeze as a serious threat rests on the presumption that the foreign carrier's goal is to establish market power in long distance services.[33] As I noted earlier, this is only one of the potential rationales for engaging in this strategy. Generating additional settlement profits and/or hindering increased competition in the foreign market (*e.g.*, by raising rivals' costs) are even more likely motivations.

In its recent foreign entry NPRM, the FCC does not address the potential for a price squeeze. The FCC argues that anticompetitive behavior can be adequately deterred by standard regulatory remedies, supplemented with some additional policies. Unfortunately, none of these address the sort of anticompetitive threat outlined above. While these additional remedies are

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[33] The FCC argues:

> "Even assuming *arguendo* that a dominant foreign carrier can unilaterally set an accounting rate, a squeeze will not succeed if the high price of a particular input can be offset by lower prices for other inputs, or economies of scale and scope, or other efficiencies. Where such offsets are possible, the integrated firm will have little or no ability to inflict substantial harm on competitors via a squeeze. AT&T has not shown that such offsets are not available to U.S. carriers. Finally, the affiliated U.S. carrier *must maintain low prices and high accounting rates over a sufficiently long time period so as to inflict substantial economic harm* to competitors." (italics and underlining added for emphasis)

appropriate and will assist in deterring a wide class of anticompetitive behavior, they would not deter the price squeeze strategy described above.

Furthermore, the regulatory remedies are reactive, not proactive. They require that harm be detected and proven, before remedial action would be undertaken. If harm occurs, it may not be reversible, especially at this critical stage in the evolution of US markets towards more effective competition. Furthermore, detecting and proving anticompetitive behavior is more difficult when a foreign carrier is involved because it is more difficult to verify the accuracy of data provided by the foreign carrier.

Adding the precondition recommended here would involve only a very minor change from the present rules but would offer a significant increase in the degree of regulatory protection afforded the competitive process in the US. The FCC has already estimated the incremental costs of terminating traffic abroad as part of its effort to establish benchmark ranges. It is clear that efficient pricing requires that settlement rates move in line with costs. Encouraging this alignment sooner seems perfectly in keeping with the spirit of the WTO. To the extent foreign carriers dispute the estimated costs of terminating traffic, the onus is on them to provide better cost data. If

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See *Report and Order in the Matter of Market Entry and Regulation of Foreign-affiliated Entities*, note 26, *supra*, paragraph 70.

available, such cost data would facilitate the transition towards effective competition abroad.

V. Conclusion

In this affidavit, I have argued that the FCC ought to require foreign carriers to adopt cost-based settlement rates as a pre-condition before granting foreign carriers the right to offer international service from the US to their home country. These cost-based rates may be approximated by the lower bound of the benchmark range, or by an improved estimate of foreign termination costs, pending the provision of appropriate cost data from the foreign carrier. Failure to adopt cost-based rates as a precondition will continue the flow of subsidies from US consumers to foreign subsidiaries, providing them with a war chest from whence to fund anticompetitive activities.

In Section II, I discuss a simple example which demonstrates the danger of a foreign carrier exploiting excess settlement rates to distort efficient competition in the US. The price squeeze strategy employed is not adequately addressed by the FCC's proposed regulatory deterrents.

The presumptive justification for unilaterally relaxing foreign entry restrictions is to increase competition in domestic long distance markets, but if these are already effectively competitive -- as suggested by most evidence -- then the competitive impact of additional entry will be small. On the other hand, the danger of foreign carriers entering US markets to